Excess Compensation

Issue

Some policy makers may question whether current statutory provisions are sufficient to mitigate the potential impact of excess compensation on the state's retirement systems. These policy makers may seek to expand the definition of excess compensation to apply to include additional compensation amounts.

This raises the following key question for policy makers considering this issue:

- ❖ Is the current definition of excess compensation sufficient, or should it be expanded?

Background

Statute defines certain types of employee compensation as "excess compensation." This includes overtime and bonuses exceeding twice the regular rate of pay and certain other payments. Employers paying excess compensation are generally billed for the increased costs to the pension system resulting from the excess compensation. According to the Department of Retirement Systems (DRS), few employer billings are triggered for overtime or bonuses under current excess compensation provisions.

During the 2012 Legislative Session, a bill was introduced that would have expanded the definition of excess compensation in all the state-administered retirement systems to capture additional compensation related to overtime, bonuses, leave cash outs, and lump sums. The bill (HB 2441) did not pass the Legislature.

Excess compensation was discussed in the general educational briefing on pension spiking given by staff at the May SCPP meeting. Following, the Executive Committee directed staff to prepare a more detailed briefing on excess compensation provisions and HB 2441.

Policy Highlights

- ❖ Excess compensation can create unexpected costs for the pension system, which may impact intergenerational equity.
- ❖ Excess compensation provisions mitigate financial impacts on the retirement systems. They do not prohibit any pay practices or directly impact benefit calculations.
- ❖ The impact of overtime and bonuses on members' benefits is not determinable at this time.
- ❖ Overtime and bonuses may serve Human Resource needs.

- ❖ Current members likely have contractual rights to use excess compensation in the calculation of their pensions.
- ❖ Changing employer billings for excess compensation does not impact contractual rights.
- ❖ Increasing employer billings for excess compensation has implications for cost sharing and plan costs. It may also provide an incentive for employers to change certain pay practices.

Analysis Of HB 2441

- ❖ Expands the definition of excess compensation. The new definition will include increases in AFC exceeding fifty percent of a member's regular* earnings over the AFC period.
- ❖ Will likely generate more employer billings for a relatively small percentage of benefit calculations.
- ❖ May provide a disincentive for certain pay practices, which could impact recruitment and retention.
- ❖ Will likely result in an indeterminate savings to the retirement systems.

**Excludes overtime, bonuses, leave cash outs, and lump sum payments.*

Next Steps

Staff will provide an initial policy briefing on excess compensation.

Materials

- ❖ Executive Summary.
- ❖ Issue Paper.
- ❖ HB 2441: Bill Language and Actuarial Fiscal Note.

O:\SCPP\2012\10-16-12_Full\3.Excess_Compensation_Exec_Summary.docx

In Brief

Issue

Statute defines certain types of employee compensation such as overtime and bonuses exceeding certain thresholds as "excess compensation." Employers are required to pay the additional costs to the retirement system for excess compensation paid to members.

Some policy makers may question whether current statutory provisions are sufficient to mitigate the potential impact of excess compensation on the state's retirement systems, and may seek to expand the provisions.

Member Impact

Excess compensation provisions do not directly impact members' benefits. However, this issue may impact any public employer paying excess compensation through increased employer billings.

Darren Painter
Policy and Research Services Manager
360.786.6155
Darren.Painter@leg.wa.gov

Excess Compensation

Current Situation

Statute defines certain types of employee compensation such as overtime and bonuses exceeding certain thresholds as "excess compensation." Employers paying excess compensation are generally billed for the additional cost to retirement system resulting from excess compensation. These provisions are designed to mitigate the financial impact of certain pay practices on the retirement systems.

Some policy makers may question whether current statutory provisions are sufficient to mitigate the potential impact of excess compensation on the state's retirement systems. These policy makers may seek to expand the definition of excess compensation to include additional compensation amounts.

During the 2012 Legislative Session, a bill was introduced that would have expanded the definition of excess compensation to capture additional compensation related to overtime, bonuses, leave cash outs, and lump-sums. The bill (HB 2441) did not pass the Legislature.

This raises the following key question for policy makers considering this issue:

- ❖ Is the current definition of excess compensation sufficient, or should it be expanded?

Background

Excess Compensation Is Defined In Statute

Statue defines certain types of employee compensation—if used in the calculation of a member's benefit—as excess compensation. This generally includes compensation beyond regular hourly wages or monthly salary. Specifically, excess compensation is defined in RCW 41.50.150 as including the following types of payments:

- ❖ A cash out of annual leave in excess of 240 hours.*
- ❖ A cash out of any other form of leave.*
- ❖ A payment for any personal expense that is reportable compensation.
- ❖ The portion of any payment, including overtime or bonuses, that exceed twice the regular rate of pay.
- ❖ Any termination or severance payment.*

The definition of excess compensation only applies to payments that impact a member's benefit calculation. Compensation paid outside a member's Average Final Compensation (AFC) ** period or directly excluded from AFC does not impact the pension calculation and does not meet the definition of excess compensation. Also, pension contributions are not collected on excluded compensation.

Excess compensation only applies to payments that impact a member's benefit calculation.

For example, the Plans 2/3 use a five year AFC period. This means that payments to a Plan 2/3 member otherwise meeting the criteria but paid more than five years prior to retirement typically won't impact the pension and would not be billed. Also, the Plans 2/3 exclude certain types of payments such as leave cash outs and severance pay from AFC. Again, these types of payments to a Plan 2/3 member won't impact the pension calculation, do not have contributions collected on them, and would not be billed. More information about what types of payments are included and excluded from AFC is provided in the educational briefing on pension spiking presented at the May SCPP meeting.

According to DRS, the majority of excess compensation billings are related to leave cash outs for Plan 1 members. Relatively few billings are created for overtime or bonuses—only 11 employer billings over the last three years.

**These payments are excluded from the salary used for pension calculations for Plan 2/3 members and no contributions are collected on them.*

***AFC is the technical term for the salary used in calculating a pension. It is generally the highest consecutive two or five years of includable compensation.*

Employers Are Generally Billed For Excess Compensation

Employers are generally billed for the present value of the increase to the member's lifetime pension benefit.

Employers paying excess compensation are generally billed for the present value of the excess compensation's increase to the member's lifetime pension benefit. These billings are calculated by the Department of Retirement Systems (DRS) at the time of retirement. DRS first calculates the increase in the member's monthly benefit attributable to the excess compensation. Then DRS calculates the actuarial present value of that increase using factors provided by actuaries.

Calculating billings at the time of retirement removes uncertainty around a member's ultimate retirement age and the compensation used in the pension calculation. Generally speaking, removing this uncertainty improves the accuracy of actuarial estimates of the cost impact of excess compensation.

Employers are also subject to public disclosure requirements before entering into an employment contract that includes excess compensation. Statute requires employers to disclose, at a public meeting, the nature of the compensation and provide an estimate of the excess compensation billings it will generate. See RCW 41.50.152.

Provisions Are Designed To Mitigate Impacts On The Retirement Systems

Billing employers for excess compensation offsets the impact on the retirement systems.

Excess compensation provisions require employers to pay for the additional cost to the retirement systems resulting from excess compensation. Billing employers for excess compensation offsets the impact on the retirement systems. It also reduces the likelihood that the costs of excess compensation are passed on to other plan participants.

Employer billings do not offset all impacts of overtime, bonuses, and cash outs on the retirement system since payments below the statutory threshold do not trigger a billing. For example, overtime and bonuses that do not exceed twice the member's regular rate of pay are not billable.

The provisions do not prohibit employers from paying certain types of compensation, nor do they prohibit the use of excess compensation when calculating a member's benefit. Other pension statutes address the types of compensation that are included and excluded from the AFC used in pension calculations. These other provisions were discussed in the educational briefing on pension spiking presented at the May SCPP meeting.

Provisions Have Been Expanded Before

Provisions were expanded in 1995 to include payments exceeding twice the regular rate of pay.

The basic excess compensation provisions were first established in 1984. At that time, an exception was made for payments made pursuant to a labor agreement currently in force. The provisions were expanded in 1995 to include payments exceeding twice the regular rate of pay. This occurred following a study of excess compensation and employer pay practices by the Joint Committee on Pension Policy.

More information on the development of excess compensation provisions is provided in **Appendix A**.

Example

John is a Plan 2 member. He retires at age 65 with 25 years of service and an AFC of $40,000. The last year he worked, his regular wage was $20/hour and he was covered by a labor agreement that provided double time and-a-half ($45/hour) for working on a holiday. John worked three holidays the year before he retired. John's excess compensation, the impact on his benefit, and the resulting employer billing are shown below:

- **Excess compensation for the three holidays is $120 calculated as follows:**
  - 24 hours * ($45/hr -2*$20/hr)=$120.
- **The excess compensation will increase his monthly benefit by $1/month calculated as follows:**
  - Accrual rate: 2%*25 years of service=50%.
  - Increase in monthly AFC: $120/60 months AFC period=$2/month.
  - Increase in monthly benefit=50%*$2/month=$1/month.
- **John's employer will be billed $143.27 for the excess compensation paid to John.** This is based on the actuarial present value factor for John's age and plan and calculated as follows:
  - $1/month increase in pension dived by .0069789 actuarial present value factor = $143.27.

Calculating billings requires many steps.

More information about the calculation of excess compensation billings and other examples are available in WAC 415-02-140.

Legislative/Committee Activity

A 2012 Bill Would Have Expanded The Definition Of Excess Compensation

During the 2012 Legislative Session, a bill was introduced that would have expanded the definition of excess compensation to capture additional compensation related to overtime, bonuses, leave cash outs, and lump-sums. The bill (HB 2441) passed the House, and the Senate Committee on Ways & Means, but did not pass the Legislature.

A bill was introduced that would have expanded the definition of excess compensation.

The bill would have included reportable compensation exceeding one and one-half times a member's base salary amount in the definition of excess compensation. The base salary amount, for purposes of the calculation, is reportable compensation excluding overtime, bonuses, leave cash-outs, and lump sum payments. The bill would have impacted all of the state-administered retirement systems.

The actuarial fiscal note indicated that, due to a lack of data, the savings that could emerge under the bill were indeterminate. Policy analysis for this bill is provided below in the **Analysis of HB 2441** section.

The SCPP Discussed Excess Compensation Earlier This Year

Excess compensation was discussed in the staff briefing on pension spiking.

The topic of excess compensation was discussed in the general educational briefing on pension spiking given by staff at the May SCPP meeting. In their discussions following the staff briefing, the Executive Committee directed staff to prepare a more detailed briefing focused on excess compensation provisions and HB 2441.

Other States

Information on excess compensation in other state plans is currently being gathered by the Washington State Institute of Public Policy (WSIPP) as part of a statutorily mandated pension study. WSIPP will be reporting the results of their study to the Legislature and the SCPP in December.

Policy Analysis

This issue raises the following key policy question:

This issue raises the key policy question of whether the current definition of excess compensation is sufficient.

- ❖ Is the current definition of excess compensation sufficient, or should it be expanded?

In responding to this issue, policy makers will likely consider the impacts of excess compensation, how often it occurs, contractual rights, and the implications of increasing employer billings for pension and Human Resources (HR) policy.

Excess Compensation Can Impact Intergenerational Equity

Excess compensation can impact intergenerational equity by increasing members' benefits beyond what was assumed for funding purposes. Intergeneration equity calls for the cost of members' benefits to be paid for by the taxpayers who received the value of the members' services. Intergenerational equity has been adopted as a goal for the Plans 2/3 by the SCPP (Goal 5e), and is codified in funding statute (RCW 41.45.010).

Pension contributions are collected over a member's career based on many actuarial assumptions including future salary increases. Cash outs, bonuses, overtime, and other types of excess compensation have the potential to increase a member's AFC beyond what is

When a member's benefit is based on a higher-than-expected AFC there is an additional cost to the system.

expected under the assumptions. When a member's benefit is based on a higher-than-expected AFC there is an additional cost to the system that emerges when the member retires. This extra cost has not been funded at retirement and is passed on to other plan participants and future generations of taxpayers. This passing on of costs runs counter to the principle of intergenerational equity.

The Impact Of Overtime/Bonuses Is Not Determinable At This Time

Policy makers evaluating whether existing excess compensation provisions are sufficient may want to know the impact of certain salary practices on members' benefits. They may further choose to focus on overtime and bonuses since these are includable* in the AFC for the state's open plans (Plans 2/3) and have received media attention in the past.

Salary data does not distinguish overtime and bonuses from other earnings.

It is not possible to determine at this time how much overtime and bonuses are increasing members' AFCs and benefits.** Actuaries cannot estimate the impact because current salary data does not distinguish overtime and bonuses from other earnings. The employer reporting system used by DRS is not capable of collecting salary data at the necessary level of detail. DRS is planning on upgrading its employer reporting system. The planned new system will allow overtime and bonuses to be distinguished from other earnings. Once the new system is up and running, it will likely take a few years of reporting for actuaries to estimate the impact of overtime and bonuses with reasonable confidence.

Staff analysis found most AFC increases fall within an expected range. However, the analysis could not identify increases by type of compensation.

While it cannot directly answer the question of overtime's impact, a staff analysis of increases in AFC for recent retirees done earlier this interim is informative. The analysis found that most increases fell within an expected range, based on long-term salary growth assumptions. Around 3 percent of recent retirees had AFC increases that clearly exceeded expectations. However, this analysis was not able to isolate overtime and bonuses from other earnings. More information on this analysis, including data, limitations, and methods, is available in the educational briefing on pension spiking presented at the May SCPP meeting.

**Other types of potential excess compensation such as leave cash outs and severance pay are excluded from the AFC for Plan 2/3 members.*

***Overtime and bonuses that remain a relatively stable percentage of a member's compensation over their career do not create unexpected costs for the retirement systems. It is when overtime and bonuses significantly increase prior to retirement that unexpected costs can occur.*

Overtime And Bonuses May Meet Some HR Needs

Policy makers seeking changes to excess compensation provisions may wish to weigh HR needs against impacts on the pension system. Billing employers for excess compensation may serve as a disincentive for certain pay practices and may limit employer flexibility in providing compensation.

Overtime may be used to manage labor shortages and bonuses may be used to recruit and retain workers.

Employers may use overtime, bonuses, and other types of compensation beyond regular wages to meet HR needs. For example, overtime may be used as a way to address temporary labor shortages without hiring additional employees. Bonuses may be used as a way to recruit and retain desired workers. In some cases, these pay practices may be standard for a particular occupation or industry and may be expected by employees. Overtime is fairly common in public safety occupations and performance bonuses are often found in certain financial services occupations. Finally, some pay practices that may result in excess compensation may be contained in collectively bargained labor agreements.

The SCPP has adopted a goal on balanced long-term management that speaks to this issue. SCPP Goal 2 calls for the pension systems to be managed in such a way as to create stability, competitiveness, and adaptability, with responsiveness to human resource policies for recruiting and retaining a quality public workforce. Given this goal, some policy makers may wish to consider whether changes to excess compensation might impact employers in a way that could negatively impact workforce management or run counter to recruitment and retention policies.

Current Members Likely Have Contractual Rights To Use Excess Compensation In Benefit Calculations

In responding to this issue, some policy makers may prefer to exclude certain types of excess compensation from AFC entirely. However, contractual rights will likely limit the flexibility of policy makers to change the definition of AFC for current members. Courts have generally held that members have a contractual right to the formula used to calculate their benefits. AFC is one component of the benefit formula and is defined in statute. Given this, current members likely have a contractual right to the current definition of AFC when calculating their benefits. This definition includes overtime, bonuses, leave cash outs*, and other types of lump sum payments.

Some policy makers may prefer to exclude certain types of compensation.

**In the Plans 1 only.*

Changing Employer Billings Does Not Impact Contractual Rights

Policy makers can likely change excess compensation provisions without raising contractual rights issues.

Unlike changing the definition of AFC, policy makers can likely change excess compensation provisions without raising issues of contractual rights. Changing employer billings for excess compensation does not have the same contractual rights implications as changing the definition of AFC. Employer billings for excess compensation do not change the formula used to calculate members' benefits and therefore do not impact members' contractual rights.

Increasing Employer Billings Has Implications For Cost Sharing And Plan Costs

Expanding the definition of excess compensation to cover more types of payments will likely increase employer billings for excess compensation. Increasing employer billings has implications for cost sharing and plan costs related to excess compensation.

Increasing billings may result in a cost sharing shift or a savings to the plan.

If employers do not change their pay practices, increased billings may result in a cost sharing shift. Increased excess compensation billings would bring additional contributions into the plan. These additional contributions will offset more of the cost of excess compensation and result in a savings to the plan. In effect, this would shift some costs related to excess compensation from all plan participants to the specific employers paying the excess compensation. However, as discussed earlier, increasing employer billings for excess compensation may cause some employers to change their pay practices.

If employers change their pay practices it may lower plan costs. Employers may choose to reduce the amount of excess compensation they pay in order to avoid higher billings. If this occurs, it may result in a decrease in the AFC used to calculate members' benefits. This would reduce the plan's liability for benefits and result in a savings to the plan.

Analysis Of HB 2441

The Executive Committee directed staff to include HB 2441 in the initial policy briefing on excess compensation. As discussed under **Legislative/Committee Activity** above, HB 2441 was introduced during the last session. The bill, if enacted, would have expanded the definition of excess compensation to capture additional compensation related to overtime, bonuses, leave cash outs, and lump-sums. This section analyzes the policy and cost implications of the changes to excess compensation provisions in this bill.

Expands The Definition Of Excess Compensation

The new provision would work with existing provisions related to overtime and bonuses to capture additional compensation.

HB 2441 expands the definition of excess compensation. The expanded definition would include increases in AFC exceeding 50 percent of a member's regular* earnings. This provision is designed to capture increases due to overtime, bonuses, leave cash outs, and other lump sum payments. These pay practices may be typical for some, but not necessarily all, employers.

The new provision would work with existing provisions related to overtime and bonuses to capture additional compensation. Current provisions are designed to address compensation increases from individual payments. The new provision is designed to addresses increases in total compensation over the AFC period. While there may be some overlap for certain payments, each provision measures excess compensation differently and would capture different amounts.

**Excludes overtime, bonuses, leave cash out, and other lump sums.*

Will Likely Generate More Employer Billings For A Relatively Small Percentage Of Benefit Calculations

The expanded definition would flag additional types of compensation as excess compensation. This will likely generate more employer billings — unless employers change their pay practices. However, it may take time for employers to change existing pay practices, particularly those in labor agreements.

A relatively small percentage of members are likely to have increases in AFC exceeding the 50 percent threshold.

As discussed earlier, a staff analysis of AFC increases for recent retirees found that most increases fell within an expected range. Around 3 percent of AFC increases exceeded expectations. For this analysis, exceeding expectations amounted to more than a 50 percent increase in compensation for a Plan 2/3 member over a 10-year period. This suggests that a relatively small percentage of members are likely to have increases in AFC exceeding the 50 percent threshold required under the bill. However, large enough increases may be perceived as abusing the system. And it may only take one to receive media attention.

While relevant to the bill analysis, the results of the AFC analysis are not directly transferable. The staff analysis measured AFC increases differently than under the bill and was not able to distinguish the source of the increase. However, the analysis does give an indication that relatively large AFC increases may occur infrequently.

May Provide A Disincentive For Certain Pay Practices, which could impact recruitment and retention

A large enough disincentive may limit employer flexibility in providing compensation.

This bill will likely increase employer billings for excess compensation and may create a disincentive for certain pay practices such as overtime, bonuses, leave cash outs, and other lump sum payments. As discussed earlier, a large enough disincentive may limit employer flexibility in providing compensation and may cause some employers to change pay practices. Changing pay practices can impact HR policies around recruitment and retention.

Will Likely Result In An Indeterminate Savings To The Retirement Systems

The actuarial fiscal note for HB 2441 indicated that this bill would likely result in a savings to the retirement systems. However, the amount of any savings is indeterminate due to lack of data.

More information on how the savings could emerge is available in the fiscal note.

Conclusion

Excess compensation provisions are designed to mitigate the impact on the retirement systems of certain pay practices such as overtime, bonuses, and cash outs. Provisions require employers to pay the additional cost to the retirement system resulting from excess compensation. Some policy makers may question whether current statutory provisions sufficiently mitigate the potential impact of excess compensation.

Policy makers may weigh potential benefits to the pension system against potential impacts on employers.

In responding to this issue, policy makers will likely consider the impacts of excess compensation, how often it occurs, contractual rights, and the implications of increasing employer billings on HR policies and plan costs. Policy makers considering an increase in employer billings for excess compensation may weigh potential benefits to the pension system against potential impacts to employers' ability to manage their workforce and recruit and retain employees.

A bill introduced during the 2012 Legislative Session would have expanded the definition of excess compensation to capture additional compensation related to overtime, bonuses, leave cash outs, and lump-sums. This bill, if enacted, would have likely generated more employer billings for a relatively small percentage of benefit calculations and resulted in a savings to the retirement systems.

Appendix A

History Of Key Developments In Excess Compensation Statute

- **1984 c 184 s 1 (SHB 843)** the excess compensation statute was created in section one of the act. It established the requirement that the employer pay the present value of retirement benefits based on excess compensation at the time of the employee's retirement. Excess compensation included, but was not limited to, lump sum payments for any form of leave, personal expenses, or severance pay.
- **1995 c 244 s 1 (SSB 5118)** calculation of excess compensation was amended to specifically include any compensation that exceeded twice the regular rate of pay. Prior to passage, the Joint Committee on Pension Policy found that certain employers appeared to avoid excess compensation charges by disguising certain types of payments as additional regular salary or overtime.
- **1995 c 387 s 1 (SB 5990)** created RCW 41.50.152, including the requirement that employers fully disclose the excess compensation impact of a proposed compensation provision at a public meeting.

O:\SCPP\2012\10-16-12_Full\3.Excess_Compensation_Issue_Paper.docx

H-3415.1

HOUSE BILL 2441

State of Washington 62nd Legislature 2012 Regular Session

By Representatives Bailey and Alexander

Read first time 01/13/12. Referred to Committee on Ways & Means.

AN ACT Relating to limiting the impact of excess compensation on state retirement system contribution rates; and amending RCW 41.50.150.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

Sec. 1. RCW 41.50.150 and 2004 c 242 s 47 are each amended to read as follows:

(1) The employer of any employee whose retirement benefits are based in part on excess compensation, as defined in this section, shall, upon receipt of a billing from the department, pay into the appropriate retirement system the present value at the time of the employee's retirement of the total estimated cost of all present and future benefits from the retirement system attributable to the excess compensation. The state actuary shall determine the estimated cost using the same method and procedure as is used in preparing fiscal note costs for the legislature. However, the director may in the director's discretion decline to bill the employer if the amount due is less than fifty dollars. Accounts unsettled within thirty days of the receipt of the billing shall be assessed an interest penalty of one percent of the amount due for each month or fraction thereof beyond the original thirty-day period.

(2) "Excess compensation," as used in this section, includes the following payments, if used in the calculation of the employee's retirement allowance:

(a) A cash out of unused annual leave in excess of two hundred forty hours of such leave. "Cash out" for purposes of this subsection means:

(i) Any payment in lieu of an accrual of annual leave; or

(ii) Any payment added to salary or wages, concurrent with a reduction of annual leave;

(b) A cash out of any other form of leave;

(c) A payment for, or in lieu of, any personal expense or transportation allowance to the extent that payment qualifies as reportable compensation in the member's retirement system;

(d) The portion of any payment, including overtime payments, that exceeds twice the regular daily or hourly rate of pay; ((~~and~~))

(e) The portion of total reportable compensation used in the calculation of the employee's retirement allowance that exceeds one and one-half times the employee's reportable compensation over the calculation period, excluding reportable compensation from overtime, bonuses, cash outs of any form of leave, or lump-sum payments; and

(f) Any termination or severance payment.

(3) This section applies to the retirement systems listed in RCW 41.50.030 and to retirements occurring on or after March 15, 1984. Nothing in this section is intended to amend or determine the meaning of any definition in chapter 2.10, 2.12, 41.26, 41.32, 41.40, 41.35, 41.37, or 43.43 RCW or to determine in any manner what payments are includable in the calculation of a retirement allowance under such chapters.

(4) An employer is not relieved of liability under this section because of the death of any person either before or after the billing from the department.

--- END ---

SUMMARY OF RESULTS

This bill expands the definition of excess compensation used for the state's retirement systems to include reportable compensation exceeding one and one-half times a base salary amount. However, due to a lack of data, the savings that could emerge under this bill is indeterminate.

More specifically, this bill could reduce retirement system liabilities if employers change their pay practices and/or could increase system assets through the collection of larger excess compensation billings from employers. The latter is essentially a cost-sharing shift from, (a) members and employers to, (b) specific employers, thus reducing contribution rates for the entire system.

HIGHLIGHTS OF ACTUARIAL ANALYSIS

This bill requires two key assumptions, including:

- Will employers change their pay practices as a result of this bill? In other words, will employers reduce or eliminate certain compensation during a member's Average Final Compensation (AFC) period or transfer such compensation to other retirement system members.
- By how much and how often will a retiring member's AFC exceed the 150 percent of base salary threshold for triggering an additional employer payment?

For illustrative purposes only, we prepared an example of how the savings could emerge if we assume that employers do not change their pay practices and assume a certain percentage of each year's new retirees trigger an excess compensation payment from employers. The results of that analysis can be found in the body of the fiscal note.

As a reminder, the savings that could emerge under this fiscal note are indeterminate. We caution the readers of this fiscal note that the actual savings the affected plans will experience could be significantly higher or lower than presented. See the remainder of this fiscal note for additional details on the summary and highlights presented here.

WHAT IS THE PROPOSED CHANGE?

Summary Of Change

This bill impacts the following systems:

- Public Employees' Retirement System (PERS).
- Teachers' Retirement System (TRS).
- School Employees' Retirement System (SERS).
- Public Safety Employees' Retirement System (PSERS).
- Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF).
- Washington State Patrol Retirement System (WSPRS).
- Judicial Retirement System (JRS).

This bill expands the definition of excess compensation to include reportable compensation exceeding one and one-half times a base salary amount. Base salary is reportable compensation excluding overtime, bonuses, leave cash-outs, and lump sum payments.

Effective Date: 90 days after session.

What Is The Current Situation?

Certain types of employee compensation used in the calculation of pensions are defined in statute as "excess compensation." Employers paying excess compensation are generally billed for the present value of the excess compensation's lifetime increase to the member's pension benefit.

Excess compensation is defined in RCW 41.50.150 as including:

- A cash-out of annual leave in excess of 240 hours.
- A cash-out of any other form of leave.
- A payment for any personal expense that is reportable compensation.
- The portion of any payment, including overtime or bonuses, that exceed twice the regular rate of pay.
- Any termination or severance payment.

Who Could Be Impacted And How?

We estimate this bill could affect all employers of these systems by requiring additional contributions to pay for excess compensation as defined under this bill. This bill could impact all 171,698 Plan 2 members of these systems through decreased contribution rates. Assuming employers do not change their pay practices, the potential decrease in contribution rates will be offset by additional assets paid by the specific employers whose retiring members' AFC triggers an excess compensation billing.

With the exception of WSPRS members, this bill will not affect member contribution rates in Plan 1 since they are fixed in statute. Additionally, this bill will not affect member contribution rates in Plan 3 since Plan 3 members do not contribute to their employer-provided defined benefit.

WHY THIS BILL COULD HAVE A SAVINGS AND WHO RECIEVES IT

Why This Bill Could Have A Savings

If employers do not modify their pay practices as a result of this bill, additional contributions will be required by individual employers to pay for the present value of the excess compensation's increase to the member's lifetime pension benefit. However, if employers do change their pay practices as a result of this bill, the AFC for retiring members could decrease.

The former will increase plan assets, whereas the latter will decrease plan liabilities. Either scenario, or a combination of both, will result in a decrease to contribution rates for the affected systems.

Who Could Receive These Savings?

The potential reduction in contribution rates from this bill will be divided between members, local employers, and the state according to standard funding methods that vary by plan:

- Plan 1 and Plan 3: 100 percent employer.
- Plan 2, WSPRS: 50 percent member and 50 percent employer.
- LEOFF 2: 50 percent member, 30 percent employer, and 20 percent state.

All employers of PERS, SERS, and PSERS members could pay lower PERS Plan 1 Unfunded Actuarial Accrued Liability (UAAL) contribution rates. Similarly, all employers of TRS members could pay lower TRS Plan 1 UAAL contribution rates.

HOW WE VALUED THE SAVINGS THAT COULD EMERGE

Below we illustrate an example of how the savings could emerge assuming that employers do not change their pay practices as a result of this bill.

Assumptions We Made

For the example below, we assumed that 0.50 percent of Plan 1 AFC and 0.25 percent of Plan 2/3 AFC would be attributable to excess compensation as defined under this bill, the cost of which would be paid by employers as a lump sum of the expected Present Value of Future Benefits (PVFB).

To get a sense for what this assumption truly represents, let's convert it into an example. Let's assume that 100 members are retiring with an average base salary of $50,000. Under this bill, any AFC greater than 150 percent of base salary would be considered excess compensation, or rather any amount more than $75,000. For the illustration below, we assumed 0.50 percent of Plan 1 AFC would be attributable to excess compensation. In our example, this is equivalent to 95 of the 100 members having an AFC of $50,000 and five members having an AFC of $80,000. The extra $5,000 AFC, or excess compensation ($80,000 - $75,000), from each of the five new retirees will be funded by their employers paying a lump sum equal to the present value of the lifetime increase in pension benefit attributable to the excess compensation.

See the How the Results Change When the Assumptions Change section of this fiscal note for details on how the results of this example could change if we assume that employers do change their pay practices.

Otherwise, we developed these costs using the same assumptions as disclosed in the *June 30, 2010, Actuarial Valuation Report* (AVR). We assumed that two-thirds of all future entrants into PERS, TRS, and SERS will choose to join Plan 2, and that the remaining one-third will enter Plan 3.

How We Applied These Assumptions

For the illustration below, we developed a model to estimate the additional assets that could be paid by individual employers. Since employers will pay for the present value of the excess compensation's increase to the member's lifetime pension benefit, we separately modeled all plan retirement benefits as a lump sum upon retirement for future new retirees instead of an on-going annuity.

From there, we assumed a certain percentage of those lump sums would be paid by individual employers (from Assumptions We Made section) as excess compensation billings. We compared and recorded projected contribution rates with and without the additional assets from increased excess compensation billings.

Otherwise, we developed these costs using the same methods as disclosed in the AVR. We used the Aggregate Funding Method to determine the fiscal budget changes for current plan members and future new entrants.

Special Data Needed

The valuation data we receive from the Department of Retirement Systems currently does not separately identify actual compensation in excess of base salary. Or rather, the reported salaries include additional payments such as overtime, cash-outs, etc. In turn, we were not able to make a reasonable comparison of AFC to the base salary.

This prevented us from setting an assumption for how prevalent and to what extent excess compensation will trigger additional payments from individual employers. As a result, the savings from this bill are indeterminate.

Otherwise, we developed these costs using the same assets and data as disclosed in the AVR.

ILLUSTRATION OF HOW SAVINGS COULD EMERGE

No Impact to the Liabilities

Assuming employers don't change pay practices, this bill does not change the PVFB of the members as shown below, so there is no impact on the actuarial funding of the affected plans due to PVFB changes.

Impact on Pension Liability			
(Dollars in Millions)	**Current**	**Increase**	**Total**
Actuarial Present Value of Projected Benefits			
(The Value of the Total Commitment to all Current Members)			
PERS 1	$12,721	$0.0	$12,721
PERS 2/3	26,041	0.0	26,041
PERS Total	**$38,762**	**$0.0**	**$38,762**
TRS 1	$9,305	$0.0	$9,305
TRS 2/3	9,111	0.0	9,111
TRS Total	**$18,416**	**$0.0**	**$18,416**
SERS 2/3	**$3,461**	**$0.0**	**$3,461**
PSERS 2	**$425**	**$0.0**	**$425**
LEOFF 1	$4,401	$0.0	$4,401
LEOFF 2	7,904	0.0	7,904
LEOFF Total	**$12,306**	**$0.0**	**$12,306**
WSPRS 1/2	**$953**	**$0.0**	**$953**
Unfunded Actuarial Accrued Liability			
*(The Portion of the Plan 1 Liability that is Amortized According to Funding Policy)**			
PERS 1	**$3,094**	**$0.0**	**$3,094**
TRS 1	**$1,345**	**$0.0**	**$1,345**
LEOFF 1	**($1,161)**	**$0.0**	**($1,161)**

Note: Totals may not agree due to rounding.
** PERS 1 and TRS 1 are amortized over a ten-year period. LEOFF 1 must be amortized by June 30, 2024.*

No Impact to Future Salaries

Assuming retirement behavior does not change, this bill does not change the Present Value of Future Salaries (PVFS) of the members as shown below so there is no impact on the actuarial funding of the affected plans due to PVFS changes.

Present Value of Future Salaries			
(Dollars in Millions)	**Current**	**Increase**	**Total**
Actuarial Present Value of Future Salaries			
(The Value of the Future Salaries Expected to be Paid to Current Members)			
PERS 2	$59,223	$0.0	$59,223
PERS 3	14,119	0.0	14,119
PERS 2/3	**$73,341**	**$0.0**	**$73,341**
TRS 2	$5,559	$0.0	$5,559
TRS 3	36,138	0.0	36,138
TRS 2/3	**$41,697**	**$0.0**	**$41,697**
SERS 2	$4,436	$0.0	$4,436
SERS 3	7,248	0.0	7,248
SERS 2/3	**$11,684**	**$0.0**	**$11,684**
PSERS 2	**$2,543**	**$0.0**	**$2,543**
LEOFF 2	**$17,360**	**$0.0**	**$17,360**
WSPRS 1/2	**$801**	**$0.0**	**$801**
UAAL Present Value of Future Salaries			
(The Value of the Future Salaries Used to Fund the UAAL)			
PERS	**$94,801**	**$0.0**	**$94,801**
TRS	**38,667**	**0.0**	**38,667**
LEOFF	**$14,581**	**$0.0**	**$14,581**

Note: Totals may not agree due to rounding.

How Contribution Rates Could Change

The decrease in the required actuarial contribution rate does not round up to the minimum supplemental contribution rate of 0.01 percent, therefore the bill will not affect contribution rates in the current biennium. However, we will use the un-rounded rate decrease shown below to measure the budget changes in future biennia for our selected example.

Employer Rate Change (2013-2037) Example Only			
	Smallest	**Average**	**Largest**
PERS 1*	0.00%	**0.00%**	0.00%
PERS 2/3	0.00%	**(0.02%)**	(0.03%)
TRS 1*	0.00%	**0.00%**	(0.01%)
TRS 2/3	0.00%	**(0.02%)**	(0.03%)
SERS 2/3	(0.01%)	**(0.02%)**	(0.03%)
PSERS 2	0.00%	**(0.01%)**	(0.02%)
LEOFF 2**	0.00%	**0.00%**	0.00%
WSPRS	0.00%	**(0.06%)**	(0.12%)

**UAAL rate change.*

***Total ER Normal Cost rate change.*

How This Could Impact Budgets And Employees

Budget Impacts – Example Only							
(Dollars in Millions)	**PERS**	**TRS**	**SERS**	**PSERS**	**LEOFF**	**WSPRS**	**Total**
Fiscal Year 2013							
General Fund	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Non-General Fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total State	**$0.0**	**$0.0**	**$0.0**	**$0.0**	**$0.0**	**$0.0**	**$0.0**
Local Government	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Employer	**$0.0**	**$0.0**	**$0.0**	**$0.0**	**$0.0**	**$0.0**	**$0.0**
Total Employee	**$0.0**	**$0.0**	**$0.0**	**$0.0**	**$0.0**	**$0.0**	**$0.0**
2013-2015							
General Fund	$0.0	($0.7)	($0.2)	$0.0	$0.0	$0.0	($0.9)
Non-General Fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total State	**$0.0**	**($0.7)**	**($0.2)**	**$0.0**	**$0.0**	**$0.0**	**($0.9)**
Local Government	0.0	(0.4)	(0.2)	0.0	0.0	0.0	(0.6)
Total Employer	**$0.0**	**($1.1)**	**($0.4)**	**$0.0**	**$0.0**	**$0.0**	**($1.4)**
Total Employee	**$0.0**	**$0.0**	**($0.2)**	**$0.0**	**$0.0**	**$0.0**	**($0.2)**
2012-2037							
General Fund	($17.3)	($31.7)	($6.1)	($0.7)	$0.0	($0.2)	($56.1)
Non-General Fund	(24.7)	0.0	0.0	(0.1)	0.0	(2.5)	(27.4)
Total State	**($42.1)**	**($31.7)**	**($6.1)**	**($0.8)**	**$0.0**	**($2.8)**	**($83.5)**
Local Government	(45.0)	(16.1)	(7.6)	(0.2)	0.0	0.0	(68.9)
Total Employer	**($87.1)**	**($47.9)**	**($13.6)**	**($1.1)**	**$0.0**	**($2.8)**	**($152.4)**
Total Employee	**($60.1)**	**($23.8)**	**($8.2)**	**($1.1)**	**$0.0**	**($0.5)**	**($93.6)**

Note: Totals may not agree due to rounding. We use long-term assumptions to produce our short-term budget impacts. Therefore, our short-term budget impacts will likely vary from estimates produced from other short-term budget models.

The analysis of this bill does not consider any other proposed changes to the systems. Our example above does not analyze the impact on JRS. The combined effect of several changes to the systems could exceed the sum of each proposed change considered individually.

As with the costs developed in the actuarial valuation, the emerging costs of the systems will vary from those presented in the AVR or this fiscal note to the extent that actual experience differs from the actuarial assumptions.

How the Risk Measures Could Change

We have not analyzed this bill using the risk assessment model. We chose not to use the risk assessment model because we do not have the resources to perform risk analysis on every bill and we don't believe this bill will materially change the risk profile of the affected systems.

HOW THE RESULTS CHANGE WHEN THE ASSUMPTIONS CHANGE

We explain how the results of our example could change if we varied our example assumption:

- Employers would not change their pay practices as a result of this bill.
- Percentage of AFC over the excess compensation threshold.

If employers were to change their pay practices to minimize the amount of excess compensation billings, the AFC for retiring members could decrease. Lowering the average salary over which retirement benefits are calculated would decrease liabilities of the affected plans. As a result, this could also lower contribution rates in the future.

The assumed percentage of AFC over the excess compensation threshold could be higher or lower than what we assumed for the example outlined in this fiscal note. This assumption is scalable; as such, doubling the assumed AFC over the excess compensation threshold would double the amount that employers would have to pay. This could be characterized as doubling the number of retirees who trigger a payment, doubling the amount of salary considered excess compensation, or a combination of both. As a result, the contribution rate decreases would also double. Similarly, cutting the assumption in half would reduce the plan savings by half.

WHAT THE READER SHOULD KNOW

The Office of the State Actuary ("we") prepared this fiscal note based on our understanding of the bill as of the date shown in the footer. We intend this fiscal note to be used by the Legislature during the 2012 Session only.

We advise readers of this fiscal note to seek professional guidance as to its content and interpretation, and not to rely upon this communication without such guidance. Please read the analysis shown in this fiscal note as a whole. Distribution of, or reliance on, only parts of this fiscal note could result in its misuse, and may mislead others.

ACTUARY'S CERTIFICATION

The undersigned hereby certifies that:

1. The actuarial cost methods are appropriate for the purposes of this pricing exercise.
2. The actuarial assumptions used are appropriate for the purposes of this pricing exercise.
3. The data on which this fiscal note is based are sufficient and reliable for the purposes of this pricing exercise.
4. Use of another set of methods, assumptions, and data may also be reasonable, and might produce different results.
5. We prepared this fiscal note for the 2012 Legislature.
6. We prepared this fiscal note and provided opinions in accordance with Washington State law and accepted actuarial standards of practice as of the date shown in the footer of this fiscal note.

The undersigned, with actuarial credentials, meets the Qualification Standards of the American Academy of Actuaries to render the actuarial opinions contained herein.

While this fiscal note is meant to be complete, the undersigned is available to provide extra advice and explanations as needed.

Matthew M. Smith, FCA, EA, MAAA
State Actuary

O:\Fiscal Notes\2012\2441_HB.docx

GLOSSARY OF ACTUARIAL TERMS

Actuarial Accrued Liability: Computed differently under different funding methods, the actuarial accrued liability generally represents the portion of the present value of fully projected benefits attributable to service credit that has been earned (or accrued) as of the valuation date.

Actuarial Present Value: The value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of actuarial assumptions (i.e. interest rate, rate of salary increases, mortality, etc.).

Aggregate Funding Method: The Aggregate Funding Method is a standard actuarial funding method. The annual cost of benefits under the Aggregate Method is equal to the normal cost. The method does not produce an unfunded actuarial accrued liability. The normal cost is determined for the entire group rather than on an individual basis.

Entry Age Normal Cost Method (EANC): The EANC method is a standard actuarial funding method. The annual cost of benefits under EANC is comprised of two components:

- ❖ Normal cost.
- ❖ Amortization of the unfunded actuarial accrued liability.

The normal cost is determined on an individual basis, from a member's age at plan entry, and is designed to be a level percentage of pay throughout a member's career.

Normal Cost: Computed differently under different funding methods, the normal cost generally represents the portion of the cost of projected benefits allocated to the current plan year.

Projected Unit Credit (PUC) Liability: The portion of the Actuarial Present Value of future benefits attributable to service credit that has been earned to date (past service).

Projected Benefits: Pension benefit amounts that are expected to be paid in the future taking into account such items as the effect of advancement in age as well as past and anticipated future compensation and service credits.

Unfunded PUC Liability: The excess, if any, of the Present Value of Benefits calculated under the PUC cost method over the Valuation Assets. This is the portion of all benefits earned to date that are not covered by plan assets.

Unfunded Actuarial Accrued Liability (UAAL): The excess, if any, of the actuarial accrued liability over the actuarial value of assets. In other words, the present value of benefits earned to date that are not covered by plan assets.